

**Testimony to the House Committee on International Relations
Subcommittee on Europe
Germany after the Elections: Implications for Germany, Europe and U.S. – German
Relations**

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Germany's Challenges: Renewal and Reform

On November 9, 2005, Germany will mark the sixteenth anniversary of the fall of the Berlin Wall and the beginning of an eleven-month rush to unification on October 3, 1990. It is therefore particularly meaningful to be offered a chance to provide commentary today on the occasion of this historical milestone in German history with a focus on what Germany has achieved, what challenges it still faces today, and what significance Germany's responses to those challenges holds for the United States.

There is no greater bond than the one the United States shares with its allies across the Atlantic. Comprised of economic, political, social and cultural shared experiences, the foundation of transatlantic relations today is deep and strong as anywhere in the world and the transatlantic relations remain of vital importance to the United States in meeting the challenges of the twenty-first century.

The transatlantic relations between Germany and the United States make up one of the most important ties across the Atlantic. It is in the interest of the United States to understand the nature of Germany's political and economic strengths and weaknesses are, what expectations we can direct at the Federal Republic during the immediate future, and how we should best manage relations with this important European partner.

Germany has the largest population in the European Union with the largest economy, and with one of the largest fielded armies in Europe, and it enjoys a role today in Europe which is unique in its long history. Within the European Union, Germany has developed a leadership role which is a result of constant nurturing of relations with its European partners, big and small. The addition of ten new members from Eastern Europe has only enhanced Germany's central role in the EU because of its traditional relations with many of these states, politically and economically. Germany's economic weight is reflected in the fact that it makes up one third of the economic output of the 12 nations which are currently part of the *Eurozone*. Germany is the largest contributor to the European Union providing nearly a quarter of the annual budget.

As the third largest economy in the world after the U.S. and Japan, Germany also is a world leader in the global marketplace. It is the world's leading exporter and shows no signs of slacking with a foreign trade surplus of over one hundred billion dollars. Exports make up one third of Germany's national output.

The United States is Germany's second largest trading partner, and Germany is the largest European exporter to the U.S. The United States has investments totaling over 110 billion euros, not counting the wave of private equity investments to the tune of thirty billion euros in the last few years. Over 2000 American companies are located in Germany with almost double that number of German companies located in the United States.

Germany is also the location of the second largest overseas deployment of U.S. forces after Iraq. Despite the conflict between Washington and Berlin over the Iraq war, Germany has in the last decade also assumed new responsibilities in the foreign policy and defense arena, with large troop contingents in Afghanistan and in the Balkans. Germany is the third largest contributor to the United Nations.

In short, Germany is a significant power in Europe, in international trade and finances and in the global strategic arena. For that reason, Germany and its future matters to the United States.

It is for all these reasons that the last few years in Germany have been a cause for worry both in and outside of the country, due to its lagging domestic economy. Germany has had a sluggish rate of domestic growth for the last decade and is projected to continue along that path in the immediate future at less than 1% in 2006. It has a seriously high unemployment rate which translates into five million people unemployed, and two million more are in subsidized job training programs. The increasing government debt (the ratio of public debt to gross domestic product) is 1.5 trillion Euros, three times the amount at the time of the fall of the Berlin Wall. The interest on that amount is more than 68 billion Euros this year, a figure which is sucking strength from Germany's future.

The problems burdening Germany's domestic economy are the result of taxation and regulatory policies, as well as generous unemployment expenditures, which have caused the individual and the corporate citizen to become discouraged from taking initiatives and risks. High taxes and expensive added costs to salaries have decreased incentives for companies to add jobs. Small and medium size firms often forgo hiring new employees due to the difficulty of downsizing because of restrictive labor laws. Others are simply moving operations a hundred kilometers or less to Eastern European states which have significantly less labor costs. High unemployment benefits have undercut the urgency among the unemployed to seek new jobs.

Additionally, German economic performance has been affected by the drag of German unification and the continuing laggard growth in Eastern Germany despite the eastward transfer of over a trillion dollars in the last fifteen years. After more than a decade, these subsidies have done little to ease East German unemployment which is double that of Western Germany.

Demographic trends are additional problems constraining German growth. The dramatic decline in birth rates in Germany and the rapidly aging – and retiring – generations are

about to make their demands on the social security and health care systems. Very few other countries in the world show the number of births relative to the population as low as in Germany. Those born in 1964 - part of the baby boom generation - are now forty years old and they did not have many children, a trend which will have a negative impact on the retiree/worker ratio in the coming decades. As in the United States, the pension system will need to introduce a combination of a later retirement age, higher contributions, more contributors, and lower benefits. Even then, public pensions will not suffice to maintain accustomed living standards for most retirees, requiring an increased reliance on supplemental private retirement savings, something to which Germans are having to adjust.

The combination of high unemployment rates and uncertain social security futures is making nervous consumers keep their wallets firmly closed, further depressing domestic consumer demand. Indeed, the German savings rate is approximately 11%, hard to imagine from an American perspective.

The initiatives taken by Chancellor Schröder to address these challenges in the past three years have shown some initial impact. Labor markets for skilled workers have become more flexible, partly through legal reforms, and through negotiation flexibility on the part of both employers and unions. Germany has been reducing tax levels and curtailing its unemployment benefits. Wage negotiations have seen a leveling off of salaries as well as increasing flexibility in reaching agreements between labor and employers throughout the country. Opening up the job market for low skilled workers remains more problematic, however. Additional reforms aimed at the structural and incentive problems contributing to high unemployment in this group are still needed for employers and employees.

After her expected election on November 22, Chancellor Merkel will need to continue where Schröder's reform left off, even though those reforms contributed to his defeat and to the poor results Ms. Merkel achieved in her campaign, which stressed that even more reforms are needed. The same public that delivered both those messages will be waiting anxiously to see what she presents after her government is finally formed.

The coalition team forming around Angela Merkel is a promising one. Both she and the recently elected head of the Social Democrats, Matthias Platzeck, represent the next generation of German leadership, following the generation of Gerhard Schröder. While both leaders are East Germans, the fact that they are trained scientists and share a common background lays the basis for constructive cooperation. They are not products of the 1968 generation in West Germany but more the products of the fifteen years since the Berlin Wall fell, seeking pragmatic answers to political challenges.

A major danger for the coalition is that, to the normal voter, the government might appear to be too focused on pain, rather than gain, on reducing expectations rather than producing real gains through reform and renewal. Taxes will go up; benefits down and the specter of unemployment will remain divisive.

To date, Merkel has not distinguished herself as a great communicator, and she will be challenged to mobilize support for a set of common goals beyond the sacrifices. If she cannot do that, she may find that the debate over reform and renewal might deteriorate into a blame game among the parties, leaving the voters without much incentive to accept change.

The process of reform and renewal will take time as can be seen from the experiences in Japan. In both cases structural change is less impeded by economic weaknesses than by insufficient political will.

As the election campaign illustrated, the public debate has often emphasized the extremes, a choice between wholesale dismantling of the social safety net or stalwart defense of the status quo. The German public is caught between these two extremes and uncertain of the way forward.

Yet, Germany has the basic requirements to confront these challenges: an educated labor force, a modern infrastructure, a key location in the largest open market in the world, and a stellar reputation as an export champion. Moreover, Germany is also not unique. The problems of high labor costs, structural rigidities, and organized political opposition to cuts in fiscal subsidies have all been dealt with by Germany's European neighbors without a full-scale demobilization of the social welfare contract Europeans have come to treasure during the past half century. Change is possible, yet not without some short-term pain for longer-term gain.

Can Angela Merkel as Chancellor in the so-called grand coalition with the Social Democrats achieve these goals? Will the Germans be willing to follow Chancellor Merkel as she seeks to guide them through the reforms and renewals Germany needs and to restore confidence in the society at large? Will the opposition parties in the Parliament play a constructive role in dealing with these issues or will they seek to block more than facilitate change?

Much of that will depend on how much support and patience the public is willing to lend the government. The benchmarks for the new government in Berlin will be the success of labor market reforms, the continuing constructive cooperation between labor unions and employers, and the creation of a business climate that is more favorable to creating and running small-scale firms, the source of most job creation. If a vigorous effort in this direction expands the labor force, both the fiscal and the demographic challenges could be met more successfully. A few years of increased growth in turn would enhance the confidence missing in the society at large.

Significant obstacles to success remain. For most Germans, the need for significant changes has not been fully grasped in a country that looks and feels so wealthy. There is no political consensus for rapid and far-reaching change. In a culture that values consensus over conflict, the lack of consensus translates into a political logjam. The obstacles to reform therefore are more political than they are economic. They are more attitudinal than institutional.

For Angela Merkel, the challenge will be to identify a specific set of goals that can be achieved during the expected legislative period of four years. That agenda will include a continued effort to enable corporate tax reform, weed out unnecessary government subsidies, find common ground on a budget including reductions in the debt, reducing non-wage labor costs and probably increasing the mandatory retirement age to 67. Whether all this can be accomplished with a coalition partner that was her adversary during the campaign will depend on the willingness of the leaderships on both sides of the aisle to agree on these goals.

The success of Germany's reforms will have important implications for Europe and the United States. The ability of Germany to meet its foreign policy responsibilities in terms of defense allocations, its presence in regional hot spots like the Balkans and the Middle East, and its role in the international financial institutions will depend on achieving a sustainable level of economic growth.

Germany is going through a transition phase, which Angela Merkel as Germany's first female Chancellor will lead. As a veteran of four decades of the German Democratic Republic and the transformation of 1989 wrought by German unification, Ms. Merkel knows what real change and transition mean. If she can communicate to a divided and skeptical public the promise and opportunity that change can bring, she may be able to effect significant change in attitudes and create a new consensus for reform.

The United States has a vested interest in Germany's success in achieving reform and renewal. Germany's capacity for partnership in leadership with the United States is a distinct advantage for American interests not only in Europe but also on the global stage.